

Trusts and insolvency - a guide

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Private wealth structures are not immune from insolvency. Here we examine the Jersey and Guernsey position from the trustee's perspective and consider the issues with which a trustee needs to be familiar.

Test for insolvency

To talk of an insolvent trust is, of course, inaccurate. A trust is not a separate legal entity and cannot, as a matter of law, be insolvent. The accounts of a trust will have been prepared as if it is a separate legal entity, but the assets and liabilities disclosed by those accounts are, in fact, the assets and liabilities of the trustee and it is to the trustee that creditors will have recourse, unless security has been granted by a trustee over the trust assets.

To determine whether a trust is or is not insolvent, the cash-flow test applies, namely the inability of the trustee to meet its debts as trustee as they fall due out of the trust property.

Change in duties

Insolvency brings about a shift towards the interests of the creditors analogous to that seen in company law and a trust that becomes insolvent should thereafter be administered on the basis that it is insolvent, treating the creditors, rather than the beneficiaries, as the persons with the economic interest in the trust. This will apply as much to third parties holding fiduciary powers in relation to the trust as it does to the trustee.

Therefore, once there is an insolvency or likely insolvency of a trust, the trustee and all those holding fiduciary powers in relation to the trust can only exercise those powers in the interests of the creditors. As the Jersey Royal Court stated in *Re Z Trusts* [2015] JRC 196C:

"The trustee or fiduciary of such a trust would be wise therefore to exercise their powers either with the consent of all of the creditors or under directions given by the Court".

A trust being administered on the basis that it is insolvent, is to be administered for the benefit

of the creditors as a class and not for the majority of them, however large that majority may be, in the same way that a liquidator of a company in a creditors' winding up owes his or her duties to the creditors of the company as a class, not to individual creditors.

What insolvency regime applies?

In the case of an insolvency or probable insolvency of a trust, the starting point for the Royal Court is to supervise the administration of the trust in the interests of the creditors as a body by way of directions given to the trustee holding office[1].

The process to be adopted will depend on the complexity of the issues faced by the trustee. The Royal Court in both Jersey and Guernsey retains discretion and flexibility to address the circumstances of an insolvent trust on its own merits.

It is well established that a trustee cannot be directed by the Court to do something outside the powers conferred upon it by the trust instrument. The trust instrument may contain a power which would allow the trustee to engage an insolvency practitioner to assist it (as necessary) in the process of winding up the trust and, if appropriate, to delegate powers to that insolvency practitioner.

There is precedent for the Court appointing receivers of a trust but it is a power to be exercised very sparingly and to our knowledge has never been done in respect of an insolvent trust. However, the Court's inherent supervisory jurisdiction is "a wide and vibrant jurisdiction"[2] and such an appointment may be appropriate in special circumstances. The Jersey Royal Court has given a few examples of such circumstances[3]:

1. Where there are lay trustees of an insolvent trust, ill-equipped to wind that trust up under the directions of the Court, then the imposition of a receiver to conduct that winding up might well be justified as being in the interests of the creditors. The views of the creditors would carry great weight.
2. Where a professional trustee has a real conflict which makes it impractical for it to conduct the winding up, even under the supervision of the Court.

Where there is a professional trustee in office with no unmanageable conflict, then it would ordinarily be much more cost effective, and therefore in the interest of the creditors, for the trustee to remain in office and to conduct the winding up process under the supervision of the Court. The approach to be adopted will likely depend on the number of claims from third party creditors seeking trust assets to be realised. In *Re Z Trusts*, the Jersey Royal Court saw little point in engaging a formal process of examining, admitting or rejecting claims in relation to the trusts because, with the exception of one claim, all of the creditor claims were accepted.

Equitable lien

A trustee is entitled to procure payment out of the trust estate or to be indemnified out of the trust estate in respect of debts properly incurred as trustee. This means that a trustee has a claim on the trust assets for the debts which it has incurred as trustee. In order to satisfy such a claim, the trustee has a right of indemnity which is secured by an equitable lien on the trust assets. That equitable lien does not depend on possession, and it normally survives after it has ceased to be a trustee. [4]

Priority rights

The decision of the Court of Appeal in *Re Z Trusts* [2019] JCA 106 considered important questions regarding the equitable rights of a former trustee and whether those rights have priority over the rights of other claimants to the assets of a trust (including successor trustees) whose liabilities exceed its assets.

The Court of Appeal reached the following conclusions:

1. a trustee's priority over the trust assets arises by virtue of its office, and ranks ahead of beneficiaries and those deriving title from them. Each trustee therefore possesses its own equitable interest and right of lien enforceable as a first charge against the trust assets;
2. the general rule that equitable interests rank according to the order of their creation applies between trustees, such that the right of lien of a former trustee ranks ahead of the right of lien of a successor trustee;
3. the trustee's equitable lien has priority over the claims of its Article 32(1)(a) creditors (which Article provides that, where a creditor knows that a trustee is acting as trustee, creditor claims will only extend to the trust property);
4. the ranking in priority exists whilst the trust 'remains solvent' and if it becomes 'insolvent'; and
5. each trustee's rights of indemnity and lien are continuing rights that do not depend upon there being any actual liability at a given point in time. Their ranking depends solely upon the date when each trustee took up appointment as trustee.

Conclusion

Trustees are entitled to expect the assistance of the court in cases of genuine difficulty and administering an insolvent trust certainly meets that criterion. Article 51 of the Trusts (Jersey) Law 1984 and section 69 of the Trusts (Guernsey) Law, 2007 confer a general discretion on the Court to make orders in relation to a trust if it thinks fit. This gives statutory recognition of the Court's equitable jurisdiction in relation to trusts.

As the Jersey Royal Court said in *Jersey Evening Post -v- Al Thani* 2002 JLR 542 its "*broad purpose is to assist those concerned with the administration of trusts to resolve their differences and to*

seek judicial guidance or direction in an orderly context but in a relatively informal and flexible manner".

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[1] Re Z Trusts [2015] JRC 214 and [2015] JRC 196C

[2] Re WW and XX [2011] JRC 231

[3] Re Z Trusts [2015] JRC 214

[4] Investec Trust (Guernsey) Ltd v Glenella Properties Ltd [2018] UKPC 7 and Re Z Trusts [2019] JCA 106

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